No. 10,644

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

LORIN A. CRANSON, *Appellant,* vs. THE UNITED STATES OF AMERICA, *Appellee.*	}

On Appeal from the District Court of the United States for the Northern District of California, Southern Division.

BRIEF FOR APPELLEE.

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BRIEF FOR APPELLEE.

OPINION BELOW.

The District Court rendered no opinion.

JURISDICTION.

This appeal involves federal income taxes for the calendar year 1936 in the amount of $51.84. The taxes in dispute were paid in equal installments on or about March 13, 1937, June 14, 1937, September 8, 1937 and December 15, 1937. (R. 3, 24, 28.) A deficiency of $9.21 was assessed and paid in two installments on March 25 and April 18, 1938. (R. 29.) A first amended claim for refund was filed on March 7, 1940 (R. 29),

and was rejected by letter dated July 22, 1941 (R. 30). On May 17, 1941, a second amended claim for refund was filed (R. 30), and was rejected by letter dated February 10, 1942 (R. 31, 57). Within the time provided in Section 3772 of the Internal Revenue Code and on April 22, 1942 (R. 23), the taxpayer brought an action in the District Court for the recovery of a portion of the taxes paid for the calendar year 1936 (R. 2-23). Jurisdiction was conferred on the District Court by Section 24, Twentieth, of the Judicial Code. The judgment was entered on October 25, 1943. (R. 62.) Within three months and on November 18, 1943, a notice of appeal was filed (R. 63), pursuant to the provisions of Section 128(a) of the Judicial Code, as amended.

QUESTIONS PRESENTED.

1. Whether the accumulated operating deficits of three wholly owned subsidiaries as of the date of their non-taxable liquidation in 1936, in the aggregate amount of $1,205,451.61, were absorbed by Honolulu Oil Corporation, Ltd., the parent corporation, thus resulting in a reduction of the earnings of Honolulu Oil Corporation, Ltd., otherwise available for dividends; or, in the alternative, whether the loss realized by Honolulu Oil Corporation, Ltd., upon the non-taxable liquidation of the wholly owned subsidiaries in 1936, in the amount of $1,225,908.63, reduced the earnings of Honolulu Oil Corporation, Ltd., available for dividends.

2. Whether the retroactive provisions of Section 501 of the Second Revenue Act of 1940, which section amends Section 115 of the Internal Revenue Code, violate the due process clause of the Fifth Amendment of the Constitution.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. i-vii.

STATEMENT.

The taxpayer sued to recover individual income taxes paid for the year 1936 in the amount of $51.84, plus statutory interest thereon. The sole issue involved in the case is the extent to which a distribution of $450.00 received by the taxpayer from the Honolulu Oil Corporation, Ltd., hereinafter referred to as "Honolulu", constituted a taxable dividend.

The case was tried solely on the pleadings and a stipulation of facts. The court below adopted the stipulation of facts as its findings of facts. (R. 60.) The pertinent stipulated facts are briefly as follows:

On August 31, 1936, Honolulu liquidated three wholly owned subsidiaries, hereinafter referred to as "subsidiaries", and took over all their assets subject to their liabilities. These liquidations constituted non-taxable transactions under Section 112(b) (6) of the Revenue Act of 1936. (R. 33.) Each of the subsidi-

aries sustained operating losses during the period from its operations, 1928 to 1933, inclusive, and as a result thereof they had an aggregate accumulated operating deficit of $1,205,451.61 as of the date of dissolution. (R. 36-37.)

These operating deficits included those sustained by the subsidiaries for January 1, 1936, to August 31, 1936. (R. 36.)

On January 1, 1936, Honolulu had available for dividends, earnings or profits accumulated since February 28, 1913, in the amount of $139,631.26. (R. 38.) In the liquidations Honolulu sustained a loss of $1,225,908.63 in the year 1936. (R. 33.) Honolulu's earnings or profits of the taxable year 1936 amounted to $931,553.82. (R. 38.) During the year 1936, Honolulu paid $1 per share dividend on each of its 937,743 shares of stock (R. 38), of which the taxpayer received $450 (R. 28-29).

By filing consolidated returns Honolulu had the tax benefit of the full amount of the operating losses of the subsidiaries for all pertinent years except 1933. (R. 37-38.)

SUMMARY OF ARGUMENT.

The operating deficits of the subsidiaries of Honolulu as of the date of their non-taxable liquidation in 1936 did not diminish the earnings or profits of Honolulu otherwise available for dividends in 1936 for the reason that the Congress in enacting Section 115 of the Revenue Act of 1936, and the Commissioner

of Internal Revenue in promulgating Article 115-3 of Treasury Regulations 94 dealt only with earnings or profits of transferor corporations. To construe Section 115 as dealing with operating deficits which the section does not mention, would be making a judicial addition to the language of the statute. But even if the surplus of Honolulu as of the beginning of the year 1936 were reduced by such deficits, Section 115(a) provides that dividends may be paid out of earnings or profits accumulated after February 28, 1913, or out of earnings or profits of the taxable year. These were more than sufficient to pay the dividends distributed by Honolulu during the year 1936.

The loss sustained by Honolulu upon the non-taxable liquidation of the subsidiaries did not diminish the earnings and profits of Honolulu available for dividends in 1936 for the same reasons that the operating deficits of the subsidiaries did not diminish the earnings of Honolulu otherwise available for dividends and for the further reason that Section 115(1) of the Internal Revenue Code was made applicable to the Revenue Act of 1936 by Section 501(c) of the Second Revenue Act of 1940. Section 115(1) provides that gain or loss realized on a transaction such as the one involved here, increases or decreases earnings or profits of a transferee corporation to, but not beyoud, the extent to which such realized gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. The word realized as used

in the section has reference to realized gains or losses which are recognized for income tax purposes such as a complete liquidation under Section 112(b) of the Revenue Act of 1936 in which no gain or loss is *"recognized."* This is clearly shown to be the construction placed on Section 115 by Congress as shown by S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25.

The retroactive application of Section 501, Second Revenue Act of 1940, does not violate the due process clause of the Fifth Amendment of the Constitution when applied here. The taxpayer has not shown that he has been hurt by the retroactive application of the section, hence, he may not challenge its constitutionality. If it is retroactive there is abundant authority to the effect that retroactive legislation applied to Revenue Acts is not violative of the Fifth Amendment. There is doubt as to whether Section 501 is retroactive or was simply an explanation or a clarifying enactment explaining and clarifying existing law including the applicable sections of the Revenue Act of 1936.

ARGUMENT.

I.

THE OPERATING DEFICITS OF THE SUBSIDIARIES AS OF THE DATE OF THEIR NON-TAXABLE LIQUIDATION DID NOT DIMINISH THE EARNINGS OR PROFITS OF HONOLULU OTHERWISE AVAILABLE FOR DIVIDENDS.

The taxpayer contends first that the operating deficits of the aforesaid subsidiaries as of August 31,

1936, the date of their liquidation, in the aggregate amount of $1,205,451.61, were absorbed by Honolulu upon the non-taxable liquidation of the subsidiaries, and diminished earnings available for dividends (Br. 9-30); or, in the alternative, that the loss sustained by Honolulu upon the liquidation of the subsidiaries on August 31, 1936, in the amount of $1,225,908.63, reduced the earnings of Honolulu available for dividends (Br. 31-34).

In support of his first contention the taxpayer is relying on the doctrine, which was first enunciated in *Commissioner v. Sansome,* 60 F. 2d 931, 933 (C.C.A. 2d), certiorari denied, 287 U. S. 667, and consistently followed by this Court and other courts. See *United States v. Kauffman,* 62 F. 2d 1045. (C.C.A. 9th.) The principle established by the decisions in those cases is that a tax free exchange, pursuant to a reorganization, does not operate to "break the continuity of the corporate life," and that, when a reorganization "does not toll the company's life as continued venture", the earnings or profits of the transferor corporation are transferred intact over to the transferee corporation and shall be considered to be earnings or profits of the transferee corporation for taxable dividend purposes. There are no decisions to the contrary. Neither the *Sansome* nor the *Kauffman* case dealt with a liquidation of a subsidiary (which obviously does "toll" the corporation's life), but Article 115-11 of Regulations 94 nevertheless recognized that the same rule applies where there is a tax-free liquidation of a subsidiary.

It is the Government's position that the aforesaid doctrine is not controlling in the instant case for the reason that all of the cases in which this doctrine was applied, dealt only with net earnings or profits of transferor corporations. This doctrine was embodied in Section 115(c) (h) of the Revenue Act of 1936 (Appendix, *infra*). It may be noted that the statute and Regulations 94, Articles 115-3 and 115-11 (Appendix, *infra*) deal only with "earnings and profits" and make no mention of operating deficits. No decided cases have been found which involved facts analogous to those presented in the instant cases, *i.e.,* cases where transferor corporations had a net operating deficit at the time they transferred their assets and liabilities to a transferee corporation, and it has been the consistent Bureau of Internal Revenue practice to disregard operating deficits in cases of this nature on the ground that neither the Revenue Acts nor the Regulations provide for diminishing surplus by such operating deficits.

The provisions of the Revenue Act of 1936, dealing with distributions in connection with reorganizations are embodied in Section 115(c) and (h) (Appendix, *infra.*) A change in Section 115(h), from the corresponding section of the Revenue Act of 1934 is explained in S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 678, 690), as follows:

> The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law,

is a non-taxable stock dividend or a distribution of stock or other exchange, on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other change. This rule is stated only in part in Section 115(h) of the Revenue Act of 1934, and corresponding provisions of prior acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner v. Sansome,* 60 Fed. (2) 931; *U. S. v. Kauffman,* 62 Fed. (2) 1045; *Murcheson v. Commissioner,* 76 Fed. (2) 641. While making no change in the rule as applied under existing law, the recommended amendment *is desirable in the interest of greater clarity.* (Italics supplied.)

Approval of that rule was again expressed in S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25, dealing with Section 501 of the Second Revenue Act of 1940, in the following language:

> Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the non-recognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. *In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings*

> *and profits of the transferee for tax purposes.* These principles are to be given full effect under section 501, I.R.C. *The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee.* [Italics supplied.]

Thus both as to reorganizations and liquidations, Congress has never asserted that the provisions of Section 115 (a), (c) or (h) are designed to permit the successor corporation to deduct the deficits of its predecessor in determining its earnings or profits. It is well settled that in the construction of a law, its meaning must first be sought in the language employed by the lawmaker (*United States v. Goldenberg,* 168 U. S. 95, 103; *United States v. Standard Brewery,* 251 U. S. 210, 217); and it is clear from the foregoing that Section 115 of the Revenue Act of 1936 neither provides for, nor was it the intent of Congress that it should provide for diminishing the surplus of a transferee corporation by operating deficits of a transferor corporation in a liquidation under Section 112 (b) (6) (Appendix, *infra*). As said in *United States v. Standard Brewery, supra* (p. 217):

> If that language be plain, it is the duty of the courts to enforce the law as written, provided it be within the constitutional authority of the legislative body, which passed it. *Lake County v. Rollins,* 130 U. S. 662, 670, 671; *Bate Refrigerat-*

ing Co. v. Sulzberger, 157 U. S. 1, 33; *United States v. First National Bank.* 234 U. S. 245, 258; *Caminetti v. United States,* 242 U. S. 470, 485. * * *

In *United States v. Goldenberg, supra,* the Court said (p. 103):

> *No mere omission, no mere failure to provide for contingencies, which it may seem wise to have specifically provided for, justify any judicial addition to the language of the statute.* * * * [Italics supplied.]

To hold that a corporation having surplus and earnings of its own in a sufficient amount to cover a distribution to its stockholders has not made a distribution of earnings and profits taxable to them because its predecessor has had an operating deficit, is in substance to hold that an exemption from income tax has been granted to the stockholders to that extent. Exemptions from taxation are never lightly to be inferred (*Heiner v. Colonial Trust Co.,* 275 U. S. 232), and will not be applied to a particular case unless granted to plain terms. *Denman v. Slayton,* 282 U. S. 514; *Anderson v. United States* 65 F. 2d 870 (C.C.A.8th). See also *Co-operative Oil Ass'n v. Commissioner,* 115 F. 2d 666 (C.C.A. 9th).

It is clear that Article 115-11 of Regulations 94 does not construe the *Sansome* principle as being applicable to deficits, even in the case of reorganizations. Nor do subsequent Regulations differ in this particular respect. Section 115(c) and (h) has also been reenacted in all subsequent Acts without any

substantial changes that would affect this question. Therefore, under "the familiar rule that a construction made by the body charged with the enforcement of a statute, which construction has long obtained in practical execution, and has been impliedly sanctioned by the reenactment of the statute without alteration in the particulars construed, when not plainly erroneous, must be treated as read into the statute." *New Haven R.R. v. Interstate Com. Com.,* 200 U. S. 361, 401-402. See also *Mass. Mutual Life Ins. Co. v. United States,* 288 U. S. 269, 273, where the court said:

> The Congress in the Revenue Acts of 1928 and 1932 reenacted section 245 without alteration. This action was taken with knowledge of the construction placed upon the section by the official charged with its administration. If the legislative body had considered the Treasury interpretation erroneous, it would have amended the section. Its failure so to do requires the conclusion that the regulation was not inconsistent with the intent of the statute * * *.

It is submitted that the Government's position with regard to the taxpayer's first contention is amply supported by the statute, Regulations and authorities mentioned above.

In this connection attention is invited to the fact that if the Court should hold, as taxpayer contends, that the doctrine in *Commissioner v. Sansome, supra,* should operate, not only in case of earnings or profits, but likewise where operating deficits are involved, then, under the specific provisions of Section 115(a)(2) of the Revenue Act of 1936, a very small

portion of the $937,430 dividends paid by Honolulu in the year 1936 could possibly constitute non-taxable dividends to the recipients thereof, for the reason that Section 115(a) contains an important provision which first appeared in that Act, to wit, that a dividend means any distribution:

> (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

This change in the 1936 Act is explained in S. Rep. No. 2156, 76th Cong., 2d Sess., p. 18 (1939-1 Cum. Bull. (Part 2) 678, 690), as follows:

> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115(a) changes the definition of a dividend so as to include *distributions out of the earnings or profits of the current taxable year.* The amendment simplifies the determination by providing that distributions during the year, *not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder* and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary. [Italics supplied.]

Furthermore, the decision in *Commissioner v. Sansome, supra,* p. 933, rationalizes that a tax free ex-

change does not operate to "break the continuity of the corporate life," and that, therefore, when a reorganization "does not toll the company's life as continued venture," the earnings of the "original, or subsidiary, company remain * * * 'earnings or profits' of the successor, or parent." The taxpayer has not shown the amounts of the operating deficits of the subsidiaries for the period January 1, to August 31, 1936. But those are the only deficits that on any theory could be material in determining earnings or profits of the taxable year. Honolulu can not deduct its own deficits for prior years and, obviously can not deduct those of another corporation.

The bookkeeping illustrations shown at pages 20-22 of taxpayer's brief are not helpful. They may illustrate "an historical record of a corporation's annual profits and losses" (Br. 21) and may also be one of the accepted methods used by bookkeepers in setting up the earned surplus account but they obviously do not show the entire picture from the income tax standpoint. For instance, they do not show "the earnings and profits of the taxable year" as contemplated by Section 115(a)(2) of the Revenue Act of 1936 and Article 115-3 of the Regulations; and they do not show that Honolulu received net assets of $464,714.63 from the liquidation (R. 59) and had received tax benefits in reduction of its net income for each of the years 1928 to 1933, inclusive, in the aggregate amount of $694,151.15 (R. 37, 38).

Likewise the Government does not agree with the taxpayer's reasoning on page 24 of his brief that

since an "operating deficit" in bookkeeping is but "a negative balance in the earned surplus account" the words "earnings and profits" as used in the statute and regulations should be interpreted to include "operating deficits." Each is the very antithesis of the other.

II.

THE LOSS SUSTAINED BY HONOLULU UPON THE NON-TAXABLE LIQUIDATION OF THE SUBSIDIARIES DID NOT DIMINISH THE EARNINGS OR PROFITS OF HONOLULU AVAILABLE FOR DIVIDENDS IN 1936.

The above is the converse of the taxpayer's alternative contention.

For income tax purposes Honolulu's investment in stocks of the subsidiaries at the date of liquidation must be reduced by $694,151.15, the amount of the subsidiaries' operating losses which was availed of to reduce the taxable income of the affiliated group in the years 1928 to 1932, inclusive. (R. 37, 38.) *Ilfeld Co. v. Hernandez,* 292 U.S. 62; *McLaughlin v. Lumber Co.,* 293 U.S. 351, 355, 357; *Inter-Island Steam Navigation, Ltd. v. Commissioner,* 42 B.T.A. 1064, 1073, 1074. The rationale of these cases is that a taxpayer having subtracted from income its losses in prior years cannot in subsequent years again deduct the losses directly or indirectly for tax purposes. Consequently, Honolulu's unrecovered investment in the stock of the subsidiaries was $531,755.48 ($1,225,906.63 less $694,151.15) instead of $1,225,906.63. (R. 33, 38.)

Whatever the amount of that loss, however, it is not deductible either in whole or in part because of the express language of Section 501 of the Revenue Act of 1940, adding subsection (1) to Section 115 of the Internal Revenue Code (Appendix, *infra*), and similarly amending all of the earlier revenue acts. Section 501(c) of that Act makes the amendment effective under each prior revenue act as if a part of such Act as of the date of its enactment. In so far as it is material here, it provides that the gain or loss realized by a corporation from the disposition of property increases or decreases its earnings or profits "to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such a sale or disposition was made." The Government had always contended that this was a correct construction of earlier statutes but had lost some of these cases and by Section 501 of the Revenue Act of 1940 Congress specifically endorsed and confirmed the Commissioner's position.[1]

As used in this provision of the law, the term "recognized" has reference to the realized gain or loss which was recognized for income tax purposes by the statute applicable to the year in which the transaction occurred. Where no gain or loss was recognized for tax purposes, as in this case, because of the provi-

[1]See H. Rep. 2894, 76th Cong., 3rd Sess., p. 41 (1940-2 Cum. Bull. 496, 526). The report specifically refers to the case of *Commissioner v. F. J. Young Corp.*, 103 F. 2d 137 (C.C.A. 3d), as one of the cases which had reached a contrary conclusion. See also *Elmhurst v. Commissioner*, 41 B.T.A. 348.

sions of Section 112(b)(6) (Appendix, *infra*), the gain or loss realized by the corporation has no effect upon the computation of earnings or profits under Section 115. See Section 29.115-11 of Regulations 111, promulgated under the Internal Revenue Code, as amended by T. D. 5304, 1943-22 Internal Revenue Bulletin 18.

This provision of the law plainly prevents the reduction of the earnings or profits of Honolulu by the amount of its unrecovered investment in stocks of the liquidated subsidiaries. There can be no question but that the statute applies[2] and if there were such a doubt, it would be removed by the fact that the Senate Report specifically refers to this situation. See S. Rep. No. 2114, 76th Cong., 3rd Sess., p. 25 (1940-2 Cum. Bull. 528, 546-547).

III.

THE RETROACTIVE APPLICATION OF SECTION 501, SECOND REVENUE ACT OF 1940, DOES NOT VIOLATE THE DUE PROCESS CLAUSE OF THE FIFTH AMENDMENT OF THE CONSTITUTION WHEN APPLIED HERE.

The taxpayer argues that to apply the provisions of Section 501 of the Revenue Act of 1940 to a determination of the taxable statute of distributions made by Honolulu in 1936 violates the due process clause of the Fifth Amendment. The argument as-

[2]This case was not pending before the District Court on October 8, 1940, the effective date of the Second Revenue Act of 1940, so that the proviso contained in Section 501(c), permitting the Board of Tax Appeals and the courts to dispose of pending cases without regard to this provision, has no application.

sumes that Section 501 is a new and retroactive law. The Committee Reports, however, show that the purpose of Congress was to clarify existing law, eliminating all controversy as to the meaning of earnings and profits in the Internal Revenue Code and the previous revenue acts. H. Rep. No. 2894, *supra*. Despite adverse decisions, the Commissioner had never ceased to urge that only to the extent that gains or losses were recognized for tax purposes should they figure in the computation of the earnings and profits of the corporation for dividend purposes. See Article 115-3 of Regulation 94, Appendix, *infra*. It is clear, therefore, that neither Honolulu nor the taxpayer had any basis for any assumption in 1936 that part of the dividends here involved would be tax exempt because Honolulu's loss on the liquidation of its subsidiaries would reduce the earnings or profits available for dividend distribution. Nor has the taxpayer shown that either made such an assumption or that no distribution would have been made except on such an assumption. Neither has been the victim of any injustice or has been hurt by the retroactive application of the statute and they have no standing to attack the constitutionality of Section 501 on the ground of objectionable retroactivity. See *Wilgard Realty Co. v. Commissioner,* 127 F. 2d 514, 517 (C.C.A. 2d).

But even if the legislation had been genuinely retroactive legislation rather than clarifying legislation, that would not serve to establish that the provision was unconstitutional. The taxpayers have cited

no case in which an income tax law has been invalid on the ground of objectionable retroactivity and we know of none. On the contrary, there are many decisions holding that retroactive provisions of income tax laws are valid. *Cooper v. United States,* 280 U. S. 409; *United States v. Hudson,* 299 U. S. 498; *Welch v. Henry,* 305 U. S. 134; *Martz v. Commissioner,* 82 F. 2d 110 (C.C.A. 9th); *Wilgard Realty Co. v. Commissioner, supra; Commissioner v. Corpus Christi T. Co.,* 126 F. 2d 898 (C.C.A. 5th); *D. W. Klein Co. v. Commissioner,* 123 F. 2d 871 (C.C.A. 7th), certiorari denied, 315 U. S. 819. The *Wilgard Realty Co.* case and the *D. W. Klein* case involving a retroactive amendment enacted in 1939 were held valid as applied to transactions occurring in 1932. See also *Commissioner v. Corpus Christi T. Co., supra.*

The Supreme Court said in *Welch v. Henry, supra,* speaking by Justice Stone,[3] now Chief Justice (pp. 146, 149):

> * * * a tax is not necessarily unconstitutional because retroactive. * * *
>
> *　　*　　*　　*　　*　　*　　*
>
> The contention that the retroactive application of the Revenue Acts is a denial of the due process guaranteed by the Fifth Amendment has been uniformly rejected. [Many cases cited.]

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[3]Although three Justices dissented from the conclusion of the majority in *Welch v. Henry,* supra, that the particular retroactive Wisconsin legislation was valid, the dissenters explicitly recognized (p. 154) that a retroactive "revision of an existing general income tax system theretofore in force" would be constitutional.

A similar contention was rejected in the case of *Wheeler v. Commissioner,* 1 T. C. 640, 645, now pending before this Court. The Tax Court held that the Congress clearly intended Section 501 of the Second Revenue Act of 1940 to apply to transactions in prior years and that such application is not unconstitutional as "in violation of the due process clause of the Fifth Amendment to the Constitution."

CONCLUSION.

The decision of the court below is correct and should, accordingly, be affirmed.

Dated, March 24, 1944.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Appendix

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(b) *Exchanges Solely in Kind.*—

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(6) *Property Received by Corporation on Complete Liquidation of Another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

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(c) *Distribution in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as a part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117(a), 100 per centum of the gain so recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of

liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years from the close of the taxable year during which is made the first of the series of distributions under the plan. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

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(h) *Effect on earnings and Profits of Distributions of Stock.*.—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation.—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

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Internal Revenue Code:

Sec. 115. [As amended by Section 501(a), Second Revenue Act of 1940, c. 757, 54 Stat. 974.] DISTRIBUTIONS BY CORPORATIONS.

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(1) *Effect on earnings and profits of gain or loss and of receipt of tax-free distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

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(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. * * *

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(26 U. S. C. 1940 ed., Sec. 115.)

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

Sec. 501. EARNINGS AND PROFITS OF CORPORATIONS.

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(c) *Under prior acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue

Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was therefore determined by, the Board of Tax Appeals, or any court of the United States.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1931, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under Section 22(a) of the Act or corresponding provisions of prior Acts. Gain and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. * * *

Art. 115-11. *Effect on earnings or profits on certain tax-free exchanges and tax-free distributions.*—If under the law applicable to the year

in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932, and for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934.